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ASSURANCE AND ACCOUNTING

FILLING THE GAAP:

New Standards for Private Companies

Background

In 2006, the Accounting Standards Board (AcSB) decided to pursue separate strategies for publicly accountable enterprises and non-publicly accountable enterprises. Publicly accountable enterprises will move to International Financial Reporting Standards (IFRS) for interim and annual periods beginning on or after January 1, 2011. For not-for-profit enterprises (NPOs), the AcSB and the Public Sector Accounting Standards Board (PSAB) plan issued two exposure drafts in March 2010 laying out their proposed plan for NPOs.

In 2007 and 2008, the AcSB spent time researching the needs of users of private enterprise financial statements to determine the direction of private enterprise standards; they issued an Invitation to Comment and held various roundtables around the country. Based on the feedback they received, the AcSB decided to develop a stand-alone set of accounting standards. The resulting standards are as follows:

- The standards maintain a common conceptual framework for both publicly accountable enterprises and private enterprises. The AcSB wants to keep the same basic financial statement concepts and definitions for the elements of financial statements (assets, liabilities, equity, revenue and expenses);
- The current Canadian Institute of Chartered Accountants' (CICA) Accounting Handbook was the starting point for the new private enterprise generally accepted accounting principles (GAAP);
- Standards that do not apply to private enterprises have been eliminated from the Handbook. A list of the Sections and Guidelines the AcSB removed appears in Appendix A;
- All EIC Abstracts were eliminated. 29 Abstracts that contain key principles addressing issues of importance to private enterprises have been incorporated into the relevant Handbook Sections in the new GAAP for private enterprises;
- The AcSB reconsidered the issues that were considered significant problem areas for private enterprises from a cost / benefit standpoint and made some simplifications;
- Disclosures were revisited for all Sections and Accounting Guidelines with a focus on what disclosures were needed for private enterprise users; and
- The recognition, measurement, and presentation requirements in the remainder of the standards in the existing Handbook remained as is.

The Result: Canadian GAAP for Private Enterprises

Applicability and Effective Date

The new standards were issued on December 15, 2009 and are effective for year ends beginning on or after January 1, 2011; early adoption is allowed. The new GAAP for Private Enterprises are stand-alone standards and all private enterprises will be given the choice of applying full IFRS or the new Canadian GAAP for Private Enterprises. All the accounting policy choices allowed will be a free choice for all private enterprises; as a result, there will no longer be any requirement for unanimous consent by shareholders or other users for different accounting policy choices, as is currently required under Section 1300, *Differential Reporting*.

Significant Changes

Disclosures

GAAP for Private Enterprises retains the overall disclosure requirement in Section 1400, *General Standards of Financial Statement Presentation* that requires an entity to provide clear and sufficient information about transactions or events that are of a size, nature or incidence that their disclosure is a necessity to understand their effect on the financial statements. With the reduction of disclosures in the Handbook, there will be more judgment required to determine what disclosure is necessary for users to understand the financial statements, but ultimately Section 1400 still requires sufficient disclosure about transactions or events to explain their effect.

Overall, the AcSB believes the reduction in the number of disclosures is significant; for example, the required disclosures for pensions have decreased approximately 60%, inventory disclosures have decreased by approximately 80% and Section 1535, *Capital Disclosures* and the requirement to disclose upcoming accounting changes (new or amended GAAP) were deleted entirely. Total required disclosures for financial instruments appear to have been reduced by approximately 25% from the level of disclosure currently required for private enterprises; compared to their public company counterparts, who are required to follow Sections 3862, *Financial Instruments – Disclosure* and 3865 – *Hedges*, private enterprises seem to have approximately 60% less required disclosure.

In determining the level of disclosure for private enterprises, the AcSB heard the users in this sector say they were most concerned with accounting policies (adopted and any changes in them), risks and uncertainties (such as going concern) and unusual events (such as subsequent events) and would not be willing to accept reductions in disclosures in these areas. Users believe those types of disclosures are necessary to understand and analyze an entity's financial statements and assess the ability of the entity to meet its future obligations. The AcSB believes users of private enterprise financial statements are more amenable to reductions in disclosures in other areas such as: assumptions used in any estimate, reconciliations of any amount on the financial statements to another amount and detailed breakdowns of figures in the financial statements, as long as, the financial statements meet the general disclosure requirement in Section 1400.

Financial Instruments

The new Section 3856, *Financial Instruments* replaces, combines or eliminates a number of Sections from the former Handbook. See Appendix A for a list of the Sections.

The highlights of the new standard are as follows:

- Most accounting choices for financial instruments have been eliminated (e.g. no classification choices like Available-for-Sale or Held-for-Trading, no settlement-date recognition option for financial assets);
- All financial assets and liabilities, with three exceptions, are measured at cost less impairment (e.g. portfolio investment in a private company) or amortized cost less impairment (e.g. accounts receivable, accounts payable, loans). The following are recorded at their fair values:
  - All free standing derivatives that are not part of a hedging relationship for which hedge accounting is used;
  - Investments in equity securities that are quoted in an active market (e.g. Royal Bank of Canada Shares);
  - Any financial asset or liability designated to be measured at fair value at inception (this election is irrevocable).
- The Section ignores all embedded derivatives except those embedded in long-term debt;
- Entities have the option to assign a zero value to the conversion option in convertible debt; thus, convertible debt can be entirely presented as a liability;
- The previous differential reporting option for redeemable preferred shares issued in certain tax planning arrangements has been hard-coded into the standard;
- There is now one impairment model for all financial assets. Previously there were different models for different items (accounts receivable, impaired loans, investments in significantly influenced entities etc.). Impairment must now be assessed for all significant assets individually. All other items may be grouped for assessing impairment based on credit risk characteristics (e.g. number of days past due, geography, industry). If there are events or circumstances that demonstrate the financial asset (or group of assets) may be impaired, it is written down to the highest of:
  - The present value of the estimated future cash flows from holding the asset(s) (discounting is not necessary for short-term items);
  - The net amount that could be realized by selling the asset at the balance sheet date; and
  - The amount the entity would receive by exercising its right to collateral to secure repayment.

  If the value increases in a future period, the item(s) may be written back up as far as its (their) original carrying value.

- For hedge accounting:
  - Hedge accounting will only be allowed when the critical terms of the hedging item and hedged item are the same; in other words, the changes in fair value or cash flows attributable to the risk being hedged are expected to offset completely;
  - Hedge accounting will be limited to the price or currency risk in an anticipated transaction, the interest-rate risk and, potentially currency risk, in an interest-bearing asset or a loan or other liability, and the foreign currency risk from the net investment in a self-sustaining foreign operation;
  - There will no longer be any requirement to document the risk management strategy and relate the relationship to a risk management objective but some documentation requirements at the inception of the hedge transaction will remain;
  - Assessments of effectiveness will not be required, but an ongoing assessment that any designated relationship continues to meet the "critical terms match" conditions will be required; and
  - The derivatives in a qualifying hedge relationship will not be accounted for at fair value; this treatment of the derivative is similar to the treatment that had been used in former Accounting Guideline 13 – "Hedge Accounting".

Future Income Taxes

Private entities will have a free choice between the taxes payable method and the future income taxes method in accounting for income taxes. Additional illustrative guidance has been provided for entities that adopt the taxes payable method to demonstrate what is required for the reconciliation of the income tax rate or expense to the statutory income tax rate or expense due to confusion in the private enterprise sector of what is required in the disclosure. An example illustration has been provided in Appendix B.

Business Combinations

The new Handbook for private enterprises replaced Sections 1581, *Business Combinations* and Section 1600, *Consolidated Financial Statements* with the new standards Section 1582, *Business Combinations*, 1601, *Consolidated Financial Statements* and 1602, *Non-controlling Interests*. Any entity choosing to apply the new Handbook has to apply the new Sections. The new business combinations model is substantially different than the previous model, but it will be the same one publicly accountable enterprises will adopt on their conversion to IFRS. See BDO Publication Canadian GAAP - IFRS Comparison Series - Issue 11 - Business Combinations for a description of the differences between current Canadian GAAP for Business Combinations and the IFRS model.

Stock-based Compensation

The current CICA Handbook includes an exception for private companies that allows them to use the minimum value method when calculating the fair value of a stock option (or its equivalent) using an option pricing model. The minimum value method ignores the volatility of the private entity's equity in the option pricing model. The minimum value method has now been removed as an option for private enterprises under revised Section 3870, *Stock-based Compensation* and Other Stock-based Payments; as a result, all private enterprises must incorporate volatility into their calculations when measuring stock-based compensation. Entities will be allowed to use the calculated value method to estimate their volatility. This method requires management to consider the size and industry of the entity and then use an appropriate sector index such as the Dow Jones Industrial Average to estimate volatility.

Goodwill and Intangible Assets

The new Section makes the current differential reporting option for impairment testing available to all private enterprises. Private enterprises will only test for impairment if there are indicators that suggest impairment.

In addition, the new Section tests for impairment of goodwill at the reporting unit level rather than mandating the additional step of allocating the fair value of the reporting unit to individual assets and liabilities, which was required previously.

Internally-developed Intangible Assets

Under Section 3064, *Goodwill and Intangible Assets*, private enterprises now have a choice between capitalizing and expensing development costs on internally generated intangible assets that meet certain criteria (the same criteria that are in the current Section 3064, *Goodwill and Intangible Assets*). Previously, entities were required to capitalize all development costs incurred on internally developed intangible assets that met the criteria.

Employee Future Benefits

A simplified method of recognition and measurement for defined benefit plans, called the immediate recognition approach, has been added to Section 3461, *Employee Future Benefits*. An entity can now make the accounting policy choice to account for all its defined benefit plans using this new approach. This method should reduce the time and costs involved in accounting for defined benefit plans. Under this method an entity will be allowed to:

- Use the actuarial valuation that is prepared for funding purposes to measure the obligation. This will eliminate the need for and cost of the actuarial valuation for accounting purposes that many entities had to obtain to account for these types of plans under GAAP; and
- Recognize all actuarial gains and losses and past service costs in net income when they occur rather than amortizing them.

The other accounting policy option is to use the defined benefit plan recognition and measurement requirements that are used currently in practice (deferral and amortization approach).

Asset Retirement Obligations (ARO)

The new Section attempts to provide a more simplified approach (based on International Accounting Standard 37, Provisions, Contingent Liabilities and Contingent Assets) to measure the ARO.

The amount that is recognized as an ARO is the best estimate of the expenditure that will be required to settle the present obligation at the end of the reporting period. The Section is less prescriptive than its predecessor and bases the estimate on management's experience and judgment.

Investments in Subsidiaries, Interests in Joint Ventures and Investments in Significantly Influenced Investees

Private Enterprises are now given the free choice to account for these investments as follows:

	Investments in Subsidiaries (Section 1590)	Interests in Joint Ventures (Section 3055)	Investments in Significantly Influenced Investees (Section 3051)
Measurement Choice	1. Consolidation 2. Cost Method 3. Equity Method	1. Proportionate Consolidation 2. Cost Method 3. Equity Method	1. Cost Method 2. Equity Method
	Note: If the investment is quoted in an active market, then fair value must be used in place of the cost method. This results in the same treatment as other equity investments that are quoted in an active market and are recorded at fair value under Section 3856, *Financial Instruments*. The consolidation and equity method options will still remain as alternative policy choices for the entity.		

As previously discussed under financial instruments, the AcSB now has one impairment model for all financial assets. Investments in subsidiaries and interests in joint ventures that are not consolidated and investments in significantly influenced investees will also be assessed for impairment using the impairment model in Section 3856, *Financial Instruments*. The old concept of assessing if an impairment is "other than temporary" will no longer exist.

Current Liabilities

The current Handbook requires all demand or callable debt to be shown as a current liability. The Handbook provides illustrative guidance to demonstrate an alternative way of presenting debt that has stated repayment terms but also is callable at the option of the holder. Entities must still show the debt as current, but they may show the debt after a subtotal for all other current liabilities. See Appendix C for an example of the balance sheet presentation and note disclosure.

New Section 1521 – *Balance Sheet*

Similar to Section 1520, *Income Statement*, this Section was drafted as a useful guide for preparers of financial statements; it is intended as a "one-stop-shop" for preparers to see what needs to be presented separately in the balance sheet, rather than having to go through various Handbook Sections. It will not add any additional presentation requirements; it only summarizes the presentation requirements of assets, liabilities and equity in one Section.

Transitional Guidance

The adoption of the new Handbook will generally require retrospective treatment; in other words, prior years' figures will have to be restated as if the Handbook had always been applied. The good news is GAAP for Private Enterprises now contains Section 1500, *First-time Adoption* that provides relief to entities that elect specific exemptions on initial adoption of GAAP for Private Enterprises. Without the Section, adopting this new GAAP for the first time could result in significant costs for entities when they apply certain sections. For example, an entity that may have never used GAAP accounting would have had to look for accounting information for business combinations from many years ago in order to comply with the Handbook; the business combination exemption will provide relief in this case. The areas for which there are possible exemptions / exceptions on first-time adoption are listed in Appendix D.

The Future for Canadian GAAP for Private Enterprises

The AcSB plans to leave the Accounting Handbook for Private Enterprises in place for at least five years, upon which, they will reassess their strategy for the sector. They intend to add new standards or make amendments to the Handbook only once every year or two to allow the sector time to adjust to changes. The AcSB continues to reiterate its plans to transition private enterprise standards so they align with IFRS.

Conclusion

Change is here for private enterprises and 2011, the year for which GAAP for Private Enterprises must be adopted, is approaching quickly. We would advise that you talk to your BDO advisor about how these changes will affect you and determine what information you need to obtain and what elections and new accounting policy options you have available to you.

APPENDIX A

Standards Removed from the GAAP for Private Enterprises

ITEMS NOT A PART OF GAAP FOR PRIVATE ENTERPRISES	EXPLANATION
Section 1300 – *Differential Reporting*	Differential reporting was created to provide relief to private enterprises. Since the Handbook is now entirely for private enterprises, the options are either hard-coded into the sections themselves as policy choices or removed, eliminating the need for the section.
Section 1530 – *Comprehensive Income* Section 3855 – *Financial Instruments — Recognition and Measurement* Section 3861 – *Financial Instruments – Disclosure and Presentation* Section 3862 – *Financial Instruments – Disclosures* Section 3863 – *Financial Instruments – Presentation* Section 3865 – *Hedges* Section 3020 – *Accounts and Notes Receivable* Section 3025 – *Impaired Loans* Section 3210 – *Long-term Debt* Accounting Guideline 4 – *Fees and Costs Associated with Lending Activities* Accounting Guideline 12 – *Transfers of Receivables* Accounting Guideline, AcG-13 – *Hedging Relationships*	The entire financial instruments suite along with Sections and Guidelines that pertained to some specific financial instruments (accounts receivable, impaired loans, long-term debt etc.) were removed and have been replaced with a new Section 3856 – *Financial Instruments*, which covers Recognition, Measurement, Presentation and Disclosure for Financial Instruments. There is now one impairment model for all financial assets.
Section 1535 – *Capital Disclosures*	The section related entirely to disclosure, has been removed as part of overall review of disclosures.
Section 1581 – *Business Combinations* Section 1600 – *Consolidated Financial Statements*	Replaced with Section 1582 – *Business Combinations*, Section 1601 – *Consolidated Financial Statements* and Section 1602 – *Non-controlling Interests*. These sections were added into the current CICA Handbook in January 2009. The new sections converge with the IFRS business combinations standards.
Section 1701 – *Segment Disclosures* Section 3500 – *Earnings Per Share* Accounting Guideline 7 – *"The Management Report"*	These Sections and Guidelines are only applicable to public companies.
Section 1751 – *Interim Financial Statements*	This section appears to be rarely used by / applicable to private enterprises. Private enterprises can look to International / US standards if they need guidance.
Section 3040 – *Prepaid Expenses*	This section was only one line which is now incorporated into Section 1510 – *Current Assets and Current Liabilities*.
Section 3480 – *Extraordinary Items*	There is no such guidance under IFRS. It did not make sense for private enterprises to have more stringent requirements than their public counterparts. Section 1400 – *General Standards of Financial Statement Presentation* still contains the general requirement to disclose transactions and events in sufficient detail for users to understand their effect.
Section 4100 – *Pension Plans*	Pension plans are not private enterprises.

Section 4211 – *Life Insurance Enterprises* Accounting Guideline 3 – *"Financial Reporting by Property and Casualty Insurance Companies"* Accounting Guideline 8 – *"Actuarial Liabilities of Life Insurance Enterprises — Disclosure"* Accounting Guideline 9 – *"Financial Reporting by Life Insurance Enterprises"*	Life insurance enterprises are not private enterprises.
Section 4250 – *Future-Oriented Financial Information*	Guidance for future-oriented financial information will be sent to the Canadian Performance Reporting Board as it is not seen as a GAAP reporting issue.
Sections 4400 to 4470 – *Not-for-Profit Organizations (NPOs)*	Currently, the private enterprise Handbook is only intended for private enterprises and not NPOs; however, the AcSB and Public Sector Accounting Board issued two exposure drafts in March 2010 and the AcSB proposes GAAP for Private Enterprises plus a suite of NPO specific standards as an option for NPOs in the private sector.
Accounting Guideline 11 – *"Enterprises in the Development Stage"*	Once changes were made to Section 3064, *Goodwill and Intangible Assets*, this Guideline no longer provided any significant additional guidance that could not be interpreted from Section 3064.
All EIC Abstracts	Public enterprises will not be required to follow EIC Abstracts once they move to IFRS so the AcSB felt that the private enterprise Handbook should not include them. Also, quite a few of the Abstracts are very prescriptive and the AcSB wants Canadian enterprises to move to a more principle-based framework similar to IFRS. Some principles from 29 Abstracts were incorporated into the private enterprise Handbook itself (e.g. leases, revenue).

APPENDIX B

Illustrative Examples of Rate Reconciliation Disclosure - Taxes Payable Method

Private enterprises can provide the rate reconciliation disclosure using the income tax rates or the income tax expense. One example of each has been provided.

Example 1 – Using the income tax expense

Note X: Income taxes

The Company accounts for income taxes using the taxes payable method. As a result, the company's income tax expense varies from the amount that would otherwise result from the application of the statutory income tax rates as set out below:

	2011	2010
Net income before income taxes	**$110,000**	$ 95,000
Expected income tax expense at the combined basic Federal and Provincial tax rate of 44% (2010 - 46%)	**$48,400**	$ 43,700
Increase (decrease) in income tax expense due to:		
Non-taxable income and non-deductible expenses	**3,000**	1,800
Income or expenses claimed in different periods for income tax purposes:		
Capital cost allowance in excess of amortization	**(3,400)**	(4,500)
Interest in net earnings of affiliate	**(10,000)**	(10,000)
	38,000	31,000
Rate adjustments:		
Small business deduction	**(18,000)**	(14,200)
Manufacturing and processing deduction	**(3,500)**	(2,700)
Income tax expense per financial statements	**$16,500**	$14,100

Example 2 – Using the income tax rates

The note is the same as the previous note except for the reconciliation which is below:

	2011	2010
Net income before income taxes	**$110,000**	$ 95,000
Combined basic federal and provincial tax rates	**44%**	46%
Increase (decrease) in income tax expense due to:		
Non-taxable income or non-deductible expense	**2%**	2%
Income or expenses claimed in different periods for income tax purposes:		
Capital cost allowance in excess of amortization	**(3%)**	(5%)
Interest in net earnings of affiliate	**(9%)**	(11%)
	34%	32%
Rate adjustments:		
Small business deduction	**(16%)**	(15%)
Manufacturing rate deduction	**(3%)**	(3%)
Effective income tax rate (Income tax expense $16,500 (2010 — $14,100).	**15%**	14%

APPENDIX C

Illustrative Example of the Presentation of Callable Debt

	2011	2010
Current		
Accounts payable and accrued liabilities	**$10,000**	$15,000
Income taxes payable	**2,000**	1,500
Deferred revenue	**1,000**	500
Scheduled cash repayments for long-term debt (Note X)	**18,000**	18,000
Current liabilities before callable debt	**31,000**	35,000
Callable debt (Note X)	**26,000**	38,000
Total current liabilities	**57,000**	73,000
Long-term debt (Note X)	**6,000**	12,000
Total liabilities	**63,000**	85,000

Note X – Long-term Debt

	2011	2010
Prime plus 2%, repayable $500 monthly plus interest, secured by equipment, due December 2013	**$12,000**	$18,000
Prime plus 3%, repayable $1,000 monthly plus interest, secured by general security agreement, callable on demand (i)	**38,000**	50,000
Total debt	**50,000**	68,000
Less: Scheduled cash repayments due within one year	**(18,000)**	(18,000)
Callable debt (i)	**(26,000)**	(38,000)
Current debt	**(44,000)**	(56,000)
Long-term debt	**$ 6,000**	$ 12,000

(i) Canadian generally accepted accounting principles require that loans that the lender can require to be repaid on demand be classified as current liabilities.

Management does not believe that the demand features of the callable debt will be exercised in the current period. Assuming payment of the callable debt is not demanded, regular principal repayments required on all long-term debt for the next five years are due as follows:

2012	$18,000
2013	18,000
2014	12,000
2015	2,000
2016	—
	$ 50,000

APPENDIX D

Transitional Guidance on First Time Adoption of Canadian GAAP for Private Enterprises

An entity may elect to use exemptions provided in the Section 1500, *First Time Adoption* related to one or more of the following on first time adoption of the new GAAP for Private Enterprises:

- Business Combinations;
- Fair Value;
- Employee Future Benefits;
- Cumulative Translation Adjustments;
- Financial Instruments;
- Stock-Based Compensation and Other Stock-based Payments
- Asset Retirement Obligations; and
- Related Party Transactions.